Ukraine's Economic Opportunities and Constraints

Externally, Ukraine's strong economic growth appears to be a picture of market success, but when examined more closely reveals numerous constraints created by incomplete reforms that mostly affect regions and SMEs. USAID's analysis of the current economic development situation has been informed by a series of contrasting images of opportunity and constraint. .

Opportunity: strong growth. While Ukraine's output contracted by 60% between 1990 and 1999, improved steel prices and increased capital inflows maintained growth rates of approximately 7% in 2006 and 2007. Living conditions have improved. In 2004 GDP per-capita finally returned to its pre-independence level (1991), but is still far behind that of its Eastern European neighbors[1]. Continued growth is the surest way for Ukraine to generate the resources needed to complete Ukraine's transformation to a market-based, democratic society.

Constraint: uneven and unsustainable growth. Ukraine's growth masks pervasive government interference in the economy and has allowed the postponement of critical reforms. While average salaries have increased, income increases and investment are concentrated in a small number of cities and industrial sectors. Furthermore, high inflation, driven by energy prices, capital inflows and government spending, threaten to dampen Ukraine's recent performance.

Opportunity: partnerships with mayors. Many of the factors, institutions and policies that contribute to competitiveness are under the influence of local governments. In Ukraine, mayors are some of the few government administrators that are directly elected by their constituents, and not appointed by the central government or selected through party lists. As a result, mayors generally act more accountably and largely view local economic development as a top priority.

Constraint: national and local government authorities are opaque. Ukrainian municipalities need to become investment-ready to identify strategic investors, take advantage of their respective assets, and to market themselves effectively. Ukraine's frequent political and administrative changes have led to an opaque legislative framework and inconsistent application of policy, particularly with regard to local economic development. Cities desperately favor changes that would give them more clearly defined relationships with the central government.

Opportunity: unleashing land constraints for FDI[2]. The availability and preparation of land for industrial and commercial use is critical for investment. Anecdotally, it is understood that 50% of land is owned by the public sector. However, ownership of land is not always clearly delineated between the different units of governments. With USAID's assistance many Ukrainian cities now better understand land issues and have cut through related red tape bringing in foreign direct investment and jobs. Ukraine can increase its FDI prospects if

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[1] Margareta Hanouz and Geiger Drzeniek. World Economic Forum, "The Ukraine Competitiveness Report 2008"

[2] Foreign direct investment is a capital expenditure by an entity resident in one country (direct investor) for an enterprise in another country with the objective of establishing a lasting interest, usually of at least 10 percent. ("Foreign Direct Investment: Putting it to work in developing countries". USAID. Feb. 2007).

the process for obtaining and converting idle or under-used land to other uses is made more efficient and less costly and wearing for investors.

Constraint: land reform is incomplete. The issue of land ownership and development holds both the greatest promise for increasing investment in Ukraine and is one of the country's greatest constraints. Multiple property registries and numerous overlapping authorities provide space for inappropriate land transactions. A transparent methodology that delineates land boundaries between municipal, raion, oblast and national governments, and a transparent and efficient process for public input on government decisions for land sale and use is absolutely critical.

Opportunity: notable regulatory progress. Over the past few years, Ukraine has taken steps to liberalize its markets and reduce the regulatory burden on business. With the assistance of a USAID-funded project, the GOU carried out the quick deregulation initiative in 2005 whereby over half of the regulations were either eliminated or amended in just over three months. "One-stop shops" have accelerated business registration and some business associations are active in shaping policy. USAID continues to assist the GOU reform laws and regulations for construction, zoning, permitting, registration and procurement areas through the MCC-funded "threshold" program.

Constraint: high regulatory barriers to business remain. While some of the time and cost related to doing business has dropped, the regulatory environment for business remains one of the central barriers for increasing enterprise productivity and foreign investment. Investors criticize Ukraine's legal system for its inefficiency, burdensome procedures, unpredictability, corruption and susceptibility to political interference. Ukraine ranks 139 out of 177 countries in the World Bank's "*Ease of Doing Business*" survey.

Opportunity: FDI is increasing[3]. FDI increases are in part due to Ukraine's comparative advantages in market size and workforce. According to the 2008 WEF "*Ukraine Competitiveness Report"*, Ukraine was ranked 26th out of 131 countries in terms of market size and 65th in Labor Market Efficiency. These conditions have enabled foreign investors to generate high enough rates of return to weather the political uncertainties and red tape. USAID has been successful in helping municipalities realize their advantages through strategic planning and attracting FDI.

Constraint: other barriers to FDI. While FDI is increasing, it is still low when compared to other prospective EU members, especially in Ukraine's regions. As discussed, the lack of a functioning and transparent land market is one of the most serious constraints for investors. Traditional land permitting process takes an average of 220 days[4]. Other barriers include the opaque and inconsistent regulatory environment. Even Belarus ranks 27 places higher than Ukraine in the World Bank's Doing Business survey. Foreign investors and businesses complain that regulations are applied in ways that are wildly inconsistent between cities. Corruption and political environment are strong risk factors for investors. Lastly, although there are investment agencies in Ukraine, these nascent organizations are experiencing "growing pains" with regards to personnel, management issues, and strategic focus.

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[3] USAID. Ukraine Economic Performance Assessment. Nathan and Associates. April 2008.

[4] MSI, "Surveys on Corruption and Business Regulation in Ukraine" May 2008.

Opportunity: integration into European markets. It is hoped that WTO membership will increase inflow of foreign investment, which the World Bank estimates could be $9 billion for 2008.[5] Work is also underway for a free trade deal with the EU. And, given the country's competitive advantages, sound strategic planning and business friendly governance would increase Ukraine's capacity to attract and absorb investments, thereby accelerating modern technology transfers and enhancing business capacity to compete globally.

Constraint: most Ukrainian enterprises are not ready for EU market opportunities. To meet WTO accession requirements, tariffs have decreased. The average applied tariff for industrial goods is down from 8.3% to 4.4%, and the average tariff on agricultural import is 13.8% (down from nearly 20%). The decreasing cost of imports will challenge Ukraine's enterprises to increase their productivity to stay alive in domestic markets, as well as to reach out to European and other markets. Ukraine's SMEs will face difficult challenges meeting international quality standards and processes (such as ISO and HACCP).

Opportunity: agricultural potential. In part, Ukraine will benefit from the global strengthening of commodity prices, especially for agricultural commodities and food. FAO estimates that for at least the next ten years agricultural commodity and food prices will be higher than the previous 30 year average. At a recent conference sponsored by EBRD and FAO in London, Ukraine, Russia and Kazakhstan were singled out as three countries capable of doubling their output, benefiting from higher prices while helping to alleviate shortages.

Constraint: failure to implement agricultural land market regulations limits growth of private farms. Much of Ukraine's agriculture is still carried out using outmoded practices from the Soviet era, resulting in low productivity and substantial post-harvest crop loss.

Trade, Investment and Competitiveness for Economic Growth

"All economic growth takes place at the level of the productive enterprise – a term encompassing producers in all sectors and of all sizes, from microenterprises and family farms to multinational corporations".[6] Individual enterprises compete in domestic and international markets, and those that are most successful in this competition are the ones that grow. Consistent and sustainable economic growth in a locality or country requires that significant numbers of its firms are successful competitors in their markets.

The competitiveness of individual firms and industries is dependent primarily on two conditions: the behavior and practices of the firms in their markets and the overall business environment in which they operate. Some industries can be highly successful even in a hostile business environment if the strength of the market opportunity is great enough. This is why countries today with extensive oil and gas deposits or other valuable natural resources can produce exceptionally high growth rates despite having business environments that are generally not favorable to enterprise competitiveness.

But most industries do not enjoy the market advantages that natural resource producers enjoy today – and for that matter a decade ago many of these same industries were on the verge of collapse

[5] UkrainianJournal.com, "Accession to the WTO will increase foreign investment, says economist" – February 04/2008
[6] Economist Arnold Harberger as quoted in the USAID Economic Growth Strategy: Securing the Future, page 13.

because of chronic over-supply and depressed prices. Manufacturing and service industries must meet the requirements of the competitive markets in regard to price, quality, reliability, and efficiency. One way of meeting the requirements of competitive markets is by adhering to recognized international standards of quality and productivity such as HAACP, ISO, CMMI, Euro Gap and other similar standards that offer the buyers assurances that the product meets the expectations of those buyers.

An important component to economic growth is investment, which should be viewed in its broadest context: improvement and expansion of physical capital (buildings, equipment, etc), enhanced labor productivity through training and skill-building, and introduction of new processes that increase efficiency and the market value of products. Both business environment improvements and firm/industry level actions should be geared to generating the type of investment activities that bring about enterprise growth.

Foreign direct investment (FDI) is often seen as superior to domestic investment for two reasons: 1) foreign investors usually have a wide range of choices for their investment locations, so when a foreign investor enters a country can be viewed as a validation of the competitiveness of that country relative to alternatives, and 2) foreign investors often bring new technology and access to external markets. Nevertheless, foreign investment should not be emphasized to the exclusion of domestic investment when either source might bring about the desired economic growth.